

7-1-1965

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Recommended Citation

Converse Murdoch, *The Scope of the Power of the Internal Revenue Service to Reallocate Under Section 482*, 6 B.C.L. Rev. 717 (1965), <http://lawdigitalcommons.bc.edu/bclr/vol6/iss4/2>

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THE SCOPE OF THE POWER OF THE INTERNAL REVENUE SERVICE TO REALLOCATE UNDER SECTION 482

CONVERSE MURDOCH*

INTRODUCTION

When compared to the more recently constructed, ornate, and sophisticated sections of the Internal Revenue Code of 1954,¹ Section 482 is almost primitive in its simplicity of style. In fact, its very simplicity makes it appear ridiculous, sitting as it does in the midst of the much more elaborate sections of the Code. It has no subsections, no definitions, no cross references, no exceptions and no mysterious effective dates. In general, it provides that the Secretary of the Treasury or his delegate may allocate among two or more commonly controlled businesses or organizations "gross income, deductions, credits or allowances" if he determines that such is necessary to "prevent evasion of taxes or clearly to reflect the income of" the businesses or organizations.²

HISTORY OF THE SECTION

The earliest ancestor of section 482 which bears an easily recognizable resemblance to it was Section 45 of the Revenue Act of 1928.³ The provision in that statute provided for allocation of gross income or deductions. No mention of credits or allowances was made.

The Ways and Means Committee report on the bill destined to become the Revenue Act of 1928⁴ explained that the section constituted a broadened version of Section 240(f) of the Revenue Act of 1926⁵ and was necessitated by the elimination of the consolidated return provisions of the 1926 Act.

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¹ Hereafter in this article the Internal Revenue Code of 1954 will be referred to simply as the "Code." The Internal Revenue Code of 1939 will be referred to as the 1939 Code.

² The full text is as follows:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades or businesses. Int. Rev. Code of 1954

§ 482.

³ Revenue Act of 1928, § 45, 45 Stat. 806.

⁴ H.R. Rep. No. 2, 70th Cong., 1st Sess. (1928).

⁵ Revenue Act of 1926, § 240(f), 44 Stat. 46.

Section 240(f) of the Revenue Act of 1926 had provided that the Commissioner might (or at the request of the taxpayer, should) "consolidate the accounts" of commonly controlled trades or businesses, if such was "necessary in order to make an accurate distribution or apportionment of gains, profits, income, deductions or capital" among the commonly controlled businesses.

There were certain striking differences between Section 240(f) of the 1926 Revenue Act and Section 45 of the 1928 Revenue Act. In the 1928 statute, the taxpayer was no longer privileged to require a reallocation. Thus the provision became solely a government sword and was no longer available as a taxpayer shield. A second (and, for present purposes, a most important) difference between the two provisions was that whereas the former permitted a consolidation of accounts of the related businesses, the latter section merely authorized the Commissioner to reallocate gross income and deductions among the related businesses. This difference was noted in the House Committee Report and explained as a change aimed at forestalling any contention that non-affiliated corporations can achieve the equivalent of a filing of a consolidated return.⁶

The House Committee Report on Section 45 of the 1928 Act⁷ mentioned the following abuses at which the section was aimed: "the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of 'milking.'"

In the Revenue Act of 1934,⁸ the corresponding section was slightly expanded to add the term "organization" to the terms "trades or businesses" used in prior law to describe the entities among which reallocations could be made. The congressional committee reports accompanying this change explained that while it was felt that prior law was broad enough to include "organizations," the change was being made to remove any doubt that the section applies to all kinds of "business activity." Absent that explanation in the committee reports, one might have assumed that the insertion of the term "organizations" was done in order to bring within the statutory provisions non-business entities such as charitable corporations.⁹

The next change in the statutory language occurred in 1943, when Section 45 of the 1939 Code was amended¹⁰ to expand the list of items

⁶ H.R. Rep. No. 2, *supra* note 4.

⁷ *Ibid.*

⁸ Revenue Act of 1934, § 45, 48 Stat. 695.

⁹ H.R. Rep. No. 704, 73d Cong., 2d Sess. (1934); S. Rep. No. 558, 73d Cong., 2d Sess. (1934). The current provision in the regulations—Treas. Reg. § 1.482-1(a)(1) (1962)—indicating that the section can be applied to exempt organizations has been approved. See *Southern College of Optometry*, 6 CCH Tax Ct. Mem. 354 (1947), upholding an earlier version of this regulation.

¹⁰ Revenue Act of 1943, § 128(b), 58 Stat. 47.

subject to reallocation. Previously, only gross income and deductions had been mentioned. The 1943 amendment added credits and allowances to the list of items subject to reallocation. The congressional committee reports accompanying this change¹¹ stated that the purpose of the insertion of the new words was to make the section coextensive with Section 129 of the 1939 Code¹² added by the same Revenue Act of 1943. In the opinion of the draftsmen of the committee reports, the changes in section 45 made no changes in then existing law.

Section 45 of the 1939 Code as last amended in 1943 has emerged virtually intact as Section 482 of the 1954 Code.

CONTROL BY SAME INTERESTS

The first step in considering the potential applicability of Code section 482 is to determine whether the two or more organizations among which allocation might be attempted are "owned or controlled directly or indirectly by the same interests." The quoted statutory language is extremely vague. The plastic nature of this part of the statute has resulted in the Treasury (in its regulations) and the courts (in their decisions) including within section 482 myriad combinations of businesses. The common control aspect of section 482 is not tied, by cross reference or otherwise, to the stock attribution rules of section 318, to the definition of controlled groups found in section 1563, or to the related taxpayers' provisions of section 267. In this regard, section 482 stands on its own.

The treasury regulations state:

[Control] includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.¹³

The last quoted sentence in the regulations smacks of "boot strap" reasoning. The Internal Revenue Service is authorized to use section 482 to prevent the arbitrary shifting of income and deductions. The determination by the Internal Revenue Service that there has been such an arbitrary shifting is presumptively correct.¹⁴ Hence, if the quoted sentence is accepted literally, the taxpayer who disputes the assertion that it is part of a commonly controlled group is faced

¹¹ H.R. Rep. No. 871, 78th Cong., 1st Sess. (1943); S. Rep. No. 627, 78th Cong., 1st Sess. (1943).

¹² This is comparable to § 269 of the 1954 Code.

¹³ Treas. Reg. § 1.482-1(a)(3) (1962).

¹⁴ 9 Mertens, Law of Federal Income Taxation § 50.61 (1942).

with a "presumption on a presumption." In litigating the issue of control, the taxpayer must win on the ultimate issue (*i.e.*, has there been arbitrary shifting of income and deductions) before he can raise the threshold issue (*i.e.*, is he part of a commonly controlled group).¹⁵

In most situations in which the Service proposes reallocations under section 482, the existence of the essential element of common control is obvious. Parent and wholly-owned subsidiary corporations, brother and sister corporations with identical stockholders owning exactly proportionate shares, and partnerships with identical partnership interests are clear examples of commonly controlled entities. Relying on the plasticity of the Code and on the breadth of the regulations, the courts have found common control in instances far removed from the clear situations just mentioned. Thus, the courts have not hesitated to amalgamate interests held by all members of a family or held by trusts for members of a family in determining the existence of common control.¹⁶ In the recent decision in *South Tex. Rice Warehouse Co.*,¹⁷ the Tax Court found common control as between a family partnership and a family corporation even though 35 percent of the stock of the corporation was owned by individuals who did not hold interests in the partnership. In reaching that result, the Tax Court relied in part on the proposition that the business operations of the partnership (drying and warehousing rice) were tied to the operations of the corporation (owning and leasing facilities for drying and storing of rice). There is no authority in the statute for concluding that businesses are commonly controlled merely because their operations are interdependent. Accordingly, the Tax Court's statement of interdependence of business operations to show common control is nothing more than a make-weight argument to support a conclusion already reached on other grounds. If mere integration of business operations were in itself sufficient to show common control, 482 would suddenly become significant in a host of situations where it has never been considered applicable. In other words, if interdependence of business operations were alone enough to show common control, an automobile manufacturer and a franchised dealer would be considered under common control on the ground that without the products of the manufacturer, the dealer would have no inventory and that concomitantly the manufacturer would have no outlet for his product in the dealer's area.

It is not possible to find an exact line of demarcation with respect to the degrees of common ownership beyond which the Service may not go in applying section 482. In General Counsel's Memorandum

¹⁵ For a demonstration of the problem just posed, see *Hall v. Commissioner*, 294 F.2d 82, 87 (5th Cir. 1961), particularly the dissenting opinion by Judge Brown.

¹⁶ *Grenada Indus., Inc.*, 17 T.C. 231 (1951), *aff'd*, 202 F.2d 873 (5th Cir. 1953).

¹⁷ 43 T.C. No. 44 (Jan. 29, 1965).

2856,¹⁸ it was stated (in considering the early ancestors of section 482) that the Board of Tax Appeals had aptly described the terms "owned or controlled directly or indirectly by the same interests" as "'doubtful' and impossible of a strict definition."

In *Cedar Valley Distillery, Inc.*,¹⁹ the Tax Court expressed doubt that there was sufficient common control for purposes of Section 45 of the 1939 Code (Section 482 of 1954 Code) as between a partnership and a corporation. There, fifty-two stockholders owned 46 percent of the corporate stock and owned no interests in the partnership; the individual who owned 54 percent of the corporation's stock had a 30 percent interest in the partnership; and another 30 percent partner had no interest of any kind in the corporation. The court held that even if there were common control of the partnership and the corporation, the circumstances did not warrant allocation of the partnership income to the corporation. Hence, the comments of the court regarding the community of control are dicta. Nonetheless, the case furnishes a bench mark—albeit a somewhat blurred one.

In *Matter of John S. Barnes, Inc.*,²⁰ a decision involving a tax claim against a bankrupt corporation, the court held that there was not the common control requisite for Section 45 of the 1939 Code where the suspect relationship was between a partnership and the debtor corporation. There, only the holders of 41.9 percent of the debtor's stock were interested in the partnership, and the debtor's stockholders held only a 35 percent interest in the partnership. Again, as in the *Cedar Valley Distillery* case, the court also found that the dealings between the two corporations were not sufficient to justify allocation under Section 45 of the 1939 Code. Nonetheless, in *Barnes*, the court flatly stated as its conclusion that the comparative degrees of common ownership meant that the community of control element of the statute was lacking.

In *A. G. Nelson Paper Co.*,²¹ the Tax Court refused to attribute stock in lessor and lessee corporations held by husbands to their wives and vice versa for the purposes of Section 45 of the 1939 Code. There the facts were particularly strong for the taxpayer: it appeared that the wives had purchased their interests in the lessor corporation with funds secured independently. The decision in *Epsen Lithographers, Inc. v. O'Malley*²² is to the same effect. In *O'Malley*, the wife's interest in the partnership was purchased with independent funds.

In summary, it may be observed that no cases have been found

¹⁸ VII-1 Cum. Bull. 128, 130 (1928).

¹⁹ 16 T.C. 870 (1951).

²⁰ 53-2 U.S. Tax Cas. ¶ 9470 (S.D. Fla. 1953).

²¹ 3 CCH Tax Ct. Mem. 914 (1944).

²² 67 F. Supp. 181 (D. Neb. 1946).

in which the courts determined that the requisite community of control did not exist without at the same time finding that there was no re-allocation justified. This is not to suggest that there could not be cases where there was lacking the community of control sufficient to bring section 482 into play while there was present an arbitrary shifting of income. It is rather to indicate that, to date, the Service has not brought such a case before a court.

DETERMINATION OF NECESSITY FOR APPLICATION OF SECTION 482

Assuming that there is present the community of control requisite for the use of section 482, the next inquiry is whether the second of the statutory conditions for use of the section is also present. That second condition is a determination by the Service that a distribution, apportionment or allocation of gross income, deductions, credits or allowances "is necessary to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades or businesses." It is significant to note that the statute speaks in terms of permitting the Service to concentrate on a determination which will clearly reflect the income of any one of the related organizations—rather than reflecting clearly the incomes of all of the organizations. This point is not discussed in the legislative history, in the regulations, or in the court decisions. However, there is no question that the statute is drafted in such a way as to permit the Service to contend that it can reallocate items toward the end of truly reflecting the income of one member of a controlled group regardless of the effect on the income of another member.

This can be a matter of more than academic interest. Where one of the corporations is subject to the income tax laws of a foreign country but not those of the United States, the problem posed by concentrating on a picture of the related corporation subject to United States jurisdiction without regard to the effect on the foreign corporation can cause serious international double taxation problems. This problem was recognized by the Service when it issued Technical Information Release 491²³ and suggested that United States taxpayers with foreign affiliates urge the latter to take steps to secure downward adjustments of foreign income taxes where the United States tax authorities were proposing increased United States taxes through what amounts to allocation of foreign income to the United States taxpayers. While the issuance of TIR 491 was presumably done with the best of motives on the part of the United States taxing authorities, in the

²³ 6 CCH 1963 Stand. Fed. Tax Rep. ¶ 6517.

In Rev. Proc. 64-54, the Service announced some relief from the double taxation effects of section 482 allocations as between United States and foreign entities with respect to taxable years beginning prior to January 1, 1963. 1964-52 Int. Rev. Bull. No. 26.

process they glossed over a most serious problem, *i.e.*, what to do if the foreign tax authorities insist that the reallocation of income by the United States authorities fails to reflect correctly the income of the foreign taxpayer. This is only one of the problems which are bound to arise when reallocations are done with regard to the income picture of only one of the related entities.

The treasury regulations provide:

The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable incomes are thereby understated, the district director shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group, shall determine the true taxable income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.²⁴

Thus, the regulations direct that when the district director finds the interdicted situation, he shall take appropriate actions to "determine the true taxable income of each controlled taxpayer." That statement in the regulations would seem to furnish good authority for the proposition that in operating under section 482 the Service has some duty of consistency of treatment of all members of the controlled group. Accordingly, in applying section 482, the Service should act in the role of an impartial arbitrator—seeking to find allocations which are fair to all controlled taxpayers. The Service should not assume the role of an advocate urging the maximum benefit for the particular entity whose increased income will produce the maximum tax revenue.

In keeping with the style of the 1954 Code and in conformity with the provisions of the Treasury Department Reorganization

²⁴ Treas. Reg. § 1.482-1(b)(1) (1962).

Plans,²⁵ section 482 gives authority to make determinations regarding the necessity of applying the section to the "Secretary [of the Treasury] or his delegate." The regulations under 482 mention only one official as having the power to act under the section—the district director of internal revenue.²⁶ In *Interstate Fire Ins. Co. v. United States*,²⁷ the taxpayer contended that the action of an examining revenue agent in proposing a reallocation of expenses as between a parent and wholly-owned subsidiary constituted an "invoking" of the section. The government denied that conclusion and argued that only a district director (and not an examining agent) had the power to invoke the section. The court in the *Interstate* case rejected the government's argument on this point by reaching the practical conclusion that the district director had redelegated to his examining agent the power to invoke section 482. That conclusion accords with the practicalities of the situation and avoids the unfairness which results from permitting the government to deny the authority of its agents after clothing them with the appearance of broad authority.

If, despite the *Interstate* decision, the government persists in contending that no revenue official other than a district director may invoke section 482, we can look forward to some intriguing procedural snarls. For example, assume a case in which a deficiency is proposed by the district director but not on the basis of a section 482 allocation and the audit result is protested to the Appellate Division. If the government's argument that only a district director may invoke section 482 is to be accepted literally, the result will be that the Appellate Division may not invoke section 482 as an additional ground to support the district director's proposed deficiency. The same argument would also cast doubt on the authority of the Appellate Division (or, for that matter, any other Treasury official) to reverse or modify the action of a district director once the latter has invoked section 482.

It is not in the least unusual for separate members of a commonly controlled group to file their tax returns in offices of different district directors. The acceptance of the government's argument in the *Interstate* case would pose some potentially insoluble procedural problems in such circumstances. Assume that corporations A and B file in different districts but are subject to sufficient common control to make section 482 potentially applicable to their affairs. Assume further that the district director for A's district determines that all of B's gross income should be reallocated to A. The district director, with whom B files its returns, accepts the return as filed, *i.e.*, without

²⁵ Reorganization Plan No. 26 of 1950 and Reorganization Plan No. 1 of 1952. Section 7804 of the 1954 Code.

²⁶ Treas. Regs. §§ 1.482-1(b)(1) and (3) (1962).

²⁷ 215 F. Supp. 586 (E.D. Tenn. 1963).

allocation of B's income to A. The problem which then arises is which district director's section 482 determination controls. An even more nightmarish situation can arise if the second district director makes a determination that under section 482 all of the income of corporation A is properly allocable to B, *i.e.*, the corporation filing in his district. It is difficult to imagine any court permitting two coordinate government officials to enforce such a grossly unfair result. However, any practitioner who has been caught in a situation where the Service is maintaining two or more concededly inconsistent positions in order "to protect the revenue" can testify that the posited situation is far from fanciful. The point is that so long as the government argues for strict construction of the regulations' provisions regarding the authority to act under section 482, these situations may very well arise. The Service owes the taxpayers an official statement which will forestall such patently unjust determinations and which will in the process repudiate the extreme argument on this point advanced in the *Interstate* case.

It is now beyond question that a reallocation under section 482 is a power given to the government but is not a procedure which can be initiated by a taxpayer.²⁸

THE SCOPE OF THE SERVICE'S AUTHORITY UNDER 482

Assuming the presence of the two basic operative circumstances (*i.e.*, the requisite community of control and a determination that reallocation is necessary to properly reflect income or prevent tax evasion), the next inquiry concerns a delimitation of precisely what the Service can and cannot do under section 482.

Consolidation of Taxable Incomes

The regulations state categorically that section 482 is not intended to "produce a result equivalent to a computation of consolidated taxable income under sub-chapter A, chapter 6 of the Code [relating to consolidating income tax returns]."²⁹ With such a flat statement in the regulations, it is surprising to find the Service using section 482 to reallocate to one taxpayer the entire net income of another taxpayer. It is even more surprising to find some courts approving this use of the section.

In a series of decisions the Tax Court has unequivocally expressed the view that section 482 and its predecessor sections permitted the Service to allocate specific items of gross income and deductions but not to allocate entire bundles of net income from one taxpayer to

²⁸ Treas. Reg. § 1.482-1(b)(3) (1962). See *First Sec. Corp. v. Clements*, 103 F.2d 1011 (6th Cir. 1939).

²⁹ Treas. Reg. § 1.482-1(b)(3) (1962).

another.³⁰ In a recent group of cases involving an attempt by the Service to ignore the separateness of so-called "multiple corporations" used in the building construction business, the Tax Court studiously avoided approving the Service's use of section 482 or its prior equivalent to combine all of the incomes of the separate corporations.³¹ One of these cases, *Kessmar Constr. Co.*,³² involved not a combining of net incomes but rather a spreading of a single surtax exemption among the multiple corporations. Nonetheless, the Court of Appeals for the Ninth Circuit specifically refused to approve or disapprove the Tax Court's reliance on section 482 as a basis for cutting down surtax exemptions.

Until 1964 the Court of Appeals for the Second Circuit stood alone in its view that section 482 could be utilized by the Service to combine the net incomes of related corporations. It adopted this position in *Advance Mach. Exch., Inc. v. Commissioner*.³³ In that case, the record was particularly damaging in its implications for the taxpayer. A sole proprietorship and three closely controlled corporations were engaged in the same business, at the same location, and utilized the same personnel. The record keeping of the members of the group was very irregular, including alteration of invoices and destruction of records before the trial. In the Tax Court the government contended that the incomes of all the entities should be taxed to the petitioner on the basis of Sections 22(a) and 45 of the 1939 Code. Reliance on the former boiled down to a contention that in reality the dealings of the other entities were sham and to be ignored. In its opinion, the Tax Court, after noting the government's reliance on both sections 22(a) and 45, concluded: "that petitioner has not shown that respondent erred in attributing to it the net income of the three other businesses, and that such income is taxable to petitioner under the broad scope of section 22(a)."³⁴ Despite the Tax Court's significant refusal to do more than approve the Commissioner's action under 22(a) (but not under 45) the Court of Appeals for the Second Circuit stated the issue to be: "Whether the Tax Court was correct in allocating income to the petitioner under § 45, I.R.C. . . ." The reviewing court went on to affirm the Tax Court's decision. In the course of its opinion, the court of appeals noted the provision in the Treasury regulations that Section

³⁰ T.V.D. Co., 27 T.C. 879, 884-85 (1957); J. I. Byrne, 16 T.C. 1234, 1243 (1951); Cedar Valley Distillery, Inc., supra note 19; Chelsea Prods., Inc., 16 T.C. 840 (1951), aff'd, 197 F.2d 620 (3d Cir. 1952); Seminole Flavor Co., 4 T.C. 1215 (1945).

³¹ Shaw Constr. Co., 35 T.C. 1102 (1961), aff'd, 323 F.2d 316 (9th Cir. 1963); Alden Homes, Inc., 33 T.C. 582 (1959).

³² 39 T.C. 778 (1963), aff'd, 336 F.2d 865 (9th Cir. 1964).

³³ 196 F.2d 1006 (2d Cir.), cert. denied, 344 U.S. 835 (1952).

³⁴ 8 CCH Tax Ct. Mem. 84, 88-89 (1949).

45 of the 1939 Code could not be used to achieve the effect of a consolidation and stated:

At first blush, this regulation would seem to support the petitioner's position but analysis shows the contrary. The effect of such an interpretation would be to exclude from the applicability of § 45 fact situations like the present one if the separate entities involved were all corporations and the Commissioner had sought to allocate all of the income from each to one of them, since this "would produce a result equivalent to a computation of consolidated net income under § 141." It may, perhaps, be sufficient for the present to point out that what was done is not, strictly, equivalent to a consolidation under § 141 since, under that section, only the income of affiliated corporations may be consolidated while here the income of a sole proprietorship was included. However, we do not rely entirely upon this distinction. Whatever valid interpretation may be given this regulation, the unsoundness of that of the petitioner is illustrated by the fact that it would exclude from the "policing" provisions of § 45 the most flagrant evasion by arbitrary shifting of income. It would let the Commissioner reallocate the income of these separate entities, to reflect the income of each correctly, if the amount involved, however great, did not equal their total combined income but he could not apply § 45 at all if the taxpayers succeeded in constructing a situation where, in order to prevent tax evasion or properly to reflect income, it were necessary to attribute all of the income of the separate entities to one of them, as was done here. Thus tax evasion could be so complete as to make itself invulnerable, a proposition whose statement discloses its fallacy.³⁵

The court of appeals gave a two-pronged answer to the taxpayer's argument. First, the court said that since the taxpayer group was not such as would qualify to file consolidated returns, the result was not the equivalent of a consolidation. This seems a hyper-technical argument. If accepted as an interpretation of the regulations, this answer would mean that section 482 could be used to accomplish a consolidation in every situation except the ones in which the law regarding consolidated returns permitted consolidation. Such would be an anomalous result. The court of appeals was not content to rely on that explanation of the regulation. It went on to state that acceptance of the taxpayer's argument would forestall correction of a situation where the

³⁵ *Advance Mach. Exch., Inc. v. Commissioner*, *supra* note 33, at 1009.

entire net income was improperly reported by the "wrong" taxpayer while permitting a reallocation of something less than the entire net income. This second answer involves logic which is unassailable if the issue was either whether the regulations should contain the provision in question or whether the statute should be amended to permit reallocations of net income. However, the court's statement is open to serious question when the inquiry involves the method of applying the regulation. Nonetheless, in the *Advance Mach.* decision, the Court of Appeals for the Second Circuit unequivocally announced its view that Section 45 of the 1939 Code could be utilized by the Commissioner to achieve what amounts to a forced consolidation. It is unfortunate that this pronouncement came in a case involving a record of taxpayer capers which undoubtedly outraged the courts.

Within two months of the announcement of the Second Circuit's decision in the *Advance Mach.* case, the Court of Appeals for the Third Circuit, in *Commissioner v. Chelsea Prods., Inc.*,³⁶ held that Section 45 of the 1939 Code did not permit reallocation of the entire net income of a taxpayer. The latter court noted the contrary position taken in the *Advance Mach.* case and referred to the statements in that case regarding section 45 as dicta, in view of the fact that the Tax Court's decision in *Advance Mach.* was based on section 22(a) rather than section 45.

Immediately after the Third Circuit's decision in *Chelsea Prods.*, the situation was as follows: the Tax Court had consistently held that section 45 could not be used to combine net incomes of related taxpayers; the Third Circuit had approved this position; and the Second Circuit had held to the contrary on the mistaken assumption that in so doing it was approving the Tax Court's position.

In *Ballentine Motor Co.*,³⁷ the Tax Court considered the situation in which a corporation previously engaged in the used car retailing business in Georgia had a sizable net operating loss. The corporation purchased used car inventories of related corporations located on South Carolina premises and proceeded to sell the inventory at the South Carolina locations until its net operating losses had been absorbed by profits. Thereafter the Georgia corporation ceased conducting South Carolina sales. The Tax Court characterized this maneuver as "tax avoidance" and "tax evasion" and held that the Commissioner was correct in utilizing section 482 to allocate the profit from the transferred South Carolina inventory away from the Georgia corporation. It is important to note that the Commissioner did not attempt to allocate all of the Georgia corporation's net income to the petitioner; rather, he merely allocated the net profit from particular transactions.

³⁶ Supra note 30.

³⁷ 39 T.C. 348 (1962), aff'd, 321 F.2d 796 (4th Cir. 1963).

The latter is hardly the equivalent of consolidating the various related corporations. In the course of its opinion in the *Ballentine Motor Co.* case, the Tax Court stated:

We believe that net income may in certain instances be properly allocated under section 45 and currently section 482. If net profits are shifted (one device at which the statute was specifically directed), it would be a logical short cut to allocate them instead of allocating "gross income, deductions, credits, [etc.]." The other devices of income shifting mentioned by the committee reports similarly suggest allocation of such income. The statute allows allocation of gross income and deductions, and to the extent this is permitted we believe it may be done as "net income."

We do not construe *Chelsea Products, Inc.*, or *T.V.D. Co.* to prevent this type of allocation. In *Chelsea Products, Inc.*, and in *T.V.D. Co.*, . . . respondent's principal arguments were that the income was earned by sham corporations, and in each case this argument was rejected on the facts. Here he is contending that income was shifted to a valid and subsisting corporation but that the transfer was to evade taxes and resulted in a distortion of income.³⁸

The Court of Appeals for the Fourth Circuit affirmed the Tax Court's decision in *Ballentine Motor Co.* without any discussion of the question of whether section 482 permits consolidations or reallocations of net income.

In *Hamburgers York Rd., Inc.*,³⁹ the Tax Court for the first time flatly rejected its own early decisions to the contrary and permitted the Commissioner to allocate the entire net income of one corporation to a related corporation. In so doing, the Tax Court accepted the reasoning of the Second Circuit in the *Advance Mach.* case.

In *Nat Harrison Associates, Inc.*,⁴⁰ the Tax Court again noted that its present position is that section 482 permits allocations of net income.

At the moment, the Tax Court and the Second Circuit Court of Appeals are of the definite opinion that 482 can be used to allocate not only a part of a taxpayer's net income, but its entire net income to a related taxpayer. The Court of Appeals for the Fourth Circuit has implicitly sanctioned the allocation of a part of net income⁴¹ and the

³⁸ Id. at 358-59.

³⁹ 41 T.C. 821 (1964).

⁴⁰ 42 T.C. 601 (1964).

⁴¹ Through its affirmance of the *Ballentine Motor Co.* decision, supra note 37.

Court of Appeals for the Third Circuit has flatly stated that section 482 cannot be used to allocate the entire net income of a corporation to another taxpayer. Absent legislative change, the issue is likely to be litigated for some time.

482 Not Usable to Create Income

The courts have consistently refused to permit the Commissioner to use section 482 to create "imputed" income where none exists.

In *Tennessee-Arkansas Gravel Co. v. Commissioner*,⁴² the taxpayer had permitted a related corporation to use its equipment without charge. The Commissioner attempted to impute rental income to the corporation which owned the equipment. The Sixth Circuit held that section 45 did not give the Commissioner the authority to "set up income where none existed." There is language in the opinion which implies that the Commissioner, had he proceeded correctly, might have achieved the same result by allocating to the taxpayer an amount of the related corporation's income equivalent to what the Commissioner determined should have been rent.

No Complete Disallowance of Actual Realized Losses and Expenses

In *General Indus. Corp.*,⁴³ one corporation sold securities at fair market value to a related corporation. The action of the Commissioner in disallowing the transferor's deduction of the resulting loss was held not supportable by section 45. Section 267 of the 1954 Code may, under appropriate circumstances, serve to disallow losses on transactions between related taxpayers, but that section, unlike section 482, is particular and limited in its application.

The *General Indus.* case involved a sale at fair market value. Where a sale between related entities has not been at fair market value, the use of Section 45 of the 1939 Code to deny losses resulting from such transactions has been approved.⁴⁴

In *Chicago & Nw. Ry.*,⁴⁵ a parent railroad corporation issued its own bonds to raise funds which were in turn lent to a subsidiary. The subsidiary became hopelessly in default on its interest payments to the parent. The Tax Court held that section 45 did not authorize the Commissioner to disallow a part of the parent's interest deductions merely because corresponding interest accruals on the loans to the subsidiary were not required to be reported in the parent's income.

⁴² 112 F.2d 508 (6th Cir. 1940). To the same effect see *E. C. Laster*, 43 B.T.A. 159 (1940), aff'd and rev'd on other grounds, 128 F.2d 4 (5th Cir. 1942); *Smith-Bridgman & Co.*, 16 T.C. 287 (1951).

⁴³ 35 B.T.A. 615 (1937).

⁴⁴ *G.U.R. Co. v. Commissioner*, 117 F.2d 187 (7th Cir. 1941).

⁴⁵ 29 T.C. 989 (1958).

Dividend Effects

Section 482 is in the nature of a "make-believe" section, in the sense that it permits computation of tax liabilities on the basis of treating transactions as if they were accomplished in a way different from the way they actually occurred. In all games of "make-believe," a point is reached at which the fiction must cease and all concerned must return to reality. The section 482 make-believe game goes smoothly as long as the only moves are those relating to shifting income and deductions and computing resulting tax liabilities. In *Walter L. Morgan*,⁴⁶ the Tax Court considered a case in which the income of corporation A had been treated as taxable to corporation B pursuant to the provisions of Section 45 of the 1939 Code. When corporation A was liquidated—with corporation B remaining in existence—the Commissioner contended that the liquidating distributions from corporation A were dividends from B. This argument was advanced on the ground that by the operation of section 45 the income of A had become part of the accumulated earnings and profits of B. The Tax Court refused to approve this use of section 45, pointing out that while section 45 authorized the distribution, apportionment, or allocation of gross income, deductions, credits or allowances, it did not expressly or impliedly authorize the distribution, apportionment or allocation of net assets, surplus or accumulated earnings and profits.

The result in the *Morgan* case should be contrasted with that in *Helvering v. Gordon*⁴⁷ where income of corporation A, diverted to corporation B and distributed by B, was treated as a dividend from A. There, the court of appeals did not rely on section 45. Rather, the court held that B was in effect acting as an agent of A and serving as a mere conduit for the transmission of A's earnings to A's stockholders.

In *Forcum-James Co.*,⁴⁸ a corporation received income under a construction contract and paid over a large part of it to a related partnership. The Tax Court upheld the action of the Commissioner in allocating the partnership income to the corporation. The Tax Court also held that such reallocated income was to be treated as a dividend from the corporation to the members of the partnership. The long range significance of the *Forcum-James* decision is doubtful due to the fact that the case was settled while on appeal. In any event, the situation in *Forcum-James* was distinguishable from that in *Morgan*.

⁴⁶ 33 T.C. 30 (1959), rev'd on another issue, 288 F.2d 676 (3d Cir.), cert. denied, 368 U.S. 836 (1961).

⁴⁷ 87 F.2d 663 (8th Cir. 1937).

⁴⁸ 7 T.C. 1195 (1946), remanded for entry of order of settlement pursuant to stipulation, 176 F.2d 311 (6th Cir. 1949).

In the former, the payment labelled a dividend actually moved from the corporation to which the income was allocated, while in the latter, the distribution in question moved from an entity other than that to which the income was allocated under section 45.

*Hugh Smith, Inc.*⁴⁹ is a decision more difficult to reconcile with the *Morgan* case. In *Hugh Smith*, the taxpayer corporation had a franchise to distribute Coca Cola, subject to an obligation to pay \$1.30 per syrup gallon to its licensor. The taxpayer granted a sub-license to its controlling stockholder with a \$1.50 gallonage charge. The controlling stockholder bypassed the taxpayer in purchasing syrup, paying the distributor \$1.30 per gallon. This was the same price provided under the taxpayer's agreement with its licensor, but 20¢ per gallon less than the price called for under the agreement between the taxpayer and its controlling stockholder. The Tax Court approved the Commissioner's use of section 45 to allocate to the taxpayer corporation an amount of its stockholder's gross income equal to 20¢ per gallon of syrup used by the stockholder. This allocation made the corporation liable for personal holding company tax. However, the Tax Court went on to hold that the income allocated from the stockholder to the corporation was in effect a dividend distribution to the stockholder. While it is difficult to reconcile the Tax Court's decisions in the *Hugh Smith* and *Morgan* cases, the Commissioner's non-acquiescence in the *Hugh Smith*⁵⁰ case is entirely consistent with his acquiescence in the somewhat contrary decision in the *Morgan* case.

In *Seminole Flavor Co.*,⁵¹ the Tax Court disapproved the Commissioner's action in allocating income of a partnership to a related corporation. The Commissioner alleged that the shifting of profits from the corporation to the partnership resulted in tax evasion. He attempted to prove this by computations which assumed that the profits reallocated to the corporation were again taxed to the partners as dividend distributions from the corporation. The Tax Court rejected this reasoning and stated that section 45 did not authorize the creation of constructive dividends. It is difficult to reconcile this result with *Hugh Smith*, but again the Commissioner's acquiescence in the *Seminole Flavor Co.* case is consistent with his non-acquiescence in the *Hugh Smith* and his acquiescence in *Morgan*.

The present situation is that the authorities support the proposition that section 482 cannot be used to create dividend income absent a conclusion that there has been an actual diversion of income, as opposed

⁴⁹ 8 T.C. 660 (1947), aff'd per curiam, 173 F.2d 224 (6th Cir.), cert. denied, 337 U.S. 918 (1949).

⁵⁰ The constructive dividend result in the *Hugh Smith* case was contrary to the contention of the Commissioner.

⁵¹ Supra note 30.

to a mere reallocation under section 482. The Commissioner has indicated his acceptance of this proposition.

The question of when the game of section 482 make-believe ends is pertinent in connection with resulting collection problems. Assume that the Service, acting pursuant to section 482, allocates all of the income of corporation A to corporation B. Assume further that this reallocation is sustained and that a court approves the assessment of a deficiency against B but does not decree that A is a sham entity whose existence is to be ignored for tax purposes. Lastly, assume that there has been no actual diversion of property from A to B and that A in fact has retained all of the reallocated income while B (the corporation against which the resulting deficiency is assessed) has no assets as of the time of the assessment. This situation places serious obstacles between the Commissioner and the enjoyment of the fruits of his section 482 victory, *viz.*, how does the Service go about collecting the deficiency which it has succeeded in assessing against a taxpayer with no assets. If, as the Tax Court held in the *Morgan* case,⁵² section 45 may not be used to reallocate assets, it is difficult to see how the Commissioner can proceed to enforce collection of B's tax liabilities out of the assets of A. The only provision of the Code which furnishes any basis for the Commissioner to proceed against B is section 6901, which relates to the collection of income tax liability from a "transferee of property" to the extent of the transferee's "liability at law or in equity." Absent a strong showing of a manipulation of funds or assets in a section 482 case, the transferee liability provisions of the law do not seem adequate to enforce liability in such a situation.

Use of 482 To Reallocate Among Succeeding Interests

The usual situation in which section 482 is employed is one in which the Service proposes to shift income or deductions from one taxpayer to another with no shift in the timing of the deduction. Thus, a typical situation occurs when A, during 1964, pays certain expenses but when the Service reallocates the deduction of such expenses to B. B is treated as having paid these expenses at the same time as they were actually paid by A, *i.e.*, during 1964.

In addition, the typical 482 situation has not involved the problem raised when a related taxpayer succeeds to the interest of another. However, section 482 may be used by the Service when a related taxpayer's income or expenses associated with an asset or a transaction is shifted to a related taxpayer from which the first taxpayer acquired an interest in the asset or transaction—or vice versa.

⁵² *Supra* note 46.

In *Tennessee Life Ins. Co. v. Phinney*⁵³ corporation S owned real estate from January 1, 1953, until January 19, 1953. On the latter date, S was liquidated into its parent—P. The Fifth Circuit approved the action of the Commissioner in allowing S to deduct only 18/365ths of the real estate taxes on its property for the year 1953. The court relied in part on the proposition that this result was in accord with S's former method of accounting for real estate taxes. However, the court went on to base its decision on the ground that the result was justified under section 45. The Fifth Circuit acknowledged that its decision was contrary to the decision of the Sixth Circuit in *Simon J. Murphy Co. v. Commissioner*.⁵⁴ In Revenue Ruling 62-45⁵⁵ the Service announced that it would not follow the *Simon J. Murphy Co.* decision but would adhere to the view it successfully advanced in *Tennessee Life Ins. Co.*

In *Rooney v. United States*,⁵⁶ the individual taxpayers had operated a hop farm until July 31, 1954, when they transferred the farm to a controlled corporation in a transaction which was tax free under section 351 of the Code. Before the transfer, the individuals incurred considerable expense in raising the crop, which crop was not sold until after the corporation became the owner. The contract for the sale of the crop had been entered into prior to the transfer to the corporation. However, the last-mentioned fact did not appear to be a decisive element in the case. The Ninth Circuit approved the Service's action in allocating the expenses of raising the crop from the individuals to the corporation which had realized the income from the crop.

The court in the *Rooney* case rejected the taxpayer's argument that the result conflicted with the provisions of section 351, providing for a tax-free transfer to a controlled corporation and a resulting use by the transferee of the transferor's basis. The Ninth Circuit held that, in effect, section 482 overrode section 351. In so deciding, the Ninth Circuit was following the decision of the Third Circuit in *National Sec. Corp. v. Commissioner*.⁵⁷

There is no question that in situations such as that posed by *Rooney* the Service can use section 482 to move deductions over to meet the related income or can shift income to meet related expenses. The latter was the technique approved in *Jud Plumbing & Heating Inc. v. Commissioner*.⁵⁸

⁵³ 280 F.2d 38 (5th Cir.), cert. denied, 364 U.S. 914 (1960).

⁵⁴ 231 F.2d 639 (6th Cir. 1956).

⁵⁵ 1962-1 Cum. Bull. 27.

⁵⁶ 305 F.2d 681 (9th Cir. 1962).

⁵⁷ 137 F.2d 600 (3d Cir.), cert. denied, 320 U.S. 794 (1943).

⁵⁸ 153 F.2d 681 (5th Cir. 1946).

The Significance of the Presence or Absence of "Good Business Purpose" in a Challenged Situation

At the present time, it is a brave tax advisor who will urge a course of action or litigate a tax case unless he can demonstrate the presence of a "good business purpose." It is difficult to imagine a tax controversy in which the taxpayer's side of the argument is not materially strengthened by a demonstrable business motive for the taxpayer's actions. It is likewise true that the absence of a good business purpose considerably improves the Service's prospects of victory. Section 482 cases are not exceptions to such a generalization. This last statement is made despite the comments of the Second Circuit in *Central Cuba Sugar Co. v. Commissioner*.⁵⁹ There, the Tax Court had disapproved the Commissioner's action in allocating expenses of producing a crop to a successor corporation which realized the income from the crop—i.e., roughly the same situation as in *Rooney*. The Tax Court based its decision on the ground that the transfer to the controlled corporation was "not primarily related to tax saving." In reversing on this point, the Second Circuit pointed out that the Tax Court's assumption of the necessity of finding some ulterior motivation—"traditionally a thankless task in tax cases and one to be avoided if possible"—was erroneous.

Despite the statement of the Second Circuit that the absence of tax motivation is insignificant for 482 purposes, the absence of tax motivation and the presence of business purposes go a long way towards enabling a taxpayer to gain a judicial reversal of a section 482 reallocation. In a number of cases the presence of a business purpose and the absence of a tax saving motive have been treated as critical. Examples are *Interior Sec. Corp.*,⁶⁰ *John Wachtel Corp.*,⁶¹ *J. E. Dilworth Co. v. Henslee*⁶² and *Jeremiah J. O'Donnell, Jr.*⁶³

THE ARM'S LENGTH TRANSACTION TEST

Once it is found that there is the community of control requisite for the use of section 482, and once the Service has determined that there must be an allocation, one is brought to the nub of the 482 problem, viz., how many dollars of the allocable items are to be shifted from one taxpayer to another. As is true in so many areas of the law, the rule to be followed in deciding this matter can be stated shortly and simply.

⁵⁹ 198 F.2d 214 (2d Cir.), cert. denied, 344 U.S. 874 (1952).

⁶⁰ 38 T.C. 330 (1962).

⁶¹ 4 CCH Tax Ct. Mem. 768 (1945).

⁶² 98 F. Supp. 957 (M.D. Tenn. 1951).

⁶³ 23 CCH Tax Ct. Mem. 210 (1964).

The application of such a short and simple rule is, however, a project of awesome proportions.

The regulations neatly sum up the standard for applying section 482 as follows:

The authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.⁶⁴

The above-quoted test has the simplicity of the classic "reasonable man" tests found in fiduciary and tort law. At the same time it contains the seed for like amounts of controversy. Once having stated the "arm's length" test, it is difficult to do other than to plunge into specific applications of the test. There is little which can be said by way of refinement of the rule *qua* rule.

In Revenue Procedure 63-10,⁶⁵ the Service published a full statement of guidelines to be used in applying section 482 for purposes of reallocating income and expenses between United States taxpayers and related organizations operating in Puerto Rico. A good part of the announcement was devoted to the matter of determining arm's length prices in the case of sales transactions between the related taxpayers. The Service stated that the best evidence of the applicable arm's length price was the "price paid in transactions between independent buyers and sellers for the same product under similar circumstances." This phraseology is nothing more than a restatement of the above-quoted part of the regulations. The balance of that part of the Revenue Procedure is devoted to a discussion of what constitutes the "same product" and "similar circumstances." The Service points out that if one of the affected taxpayers makes comparable purchases from independent sources, the prices applicable to such other transactions by the particular taxpayer will be acceptable as a gauge unless such other prices are "artificial" or "unrealistic." Again, this statement of the rule is of little assistance in a solution of a particular case. The ruling goes on to mention a host of factors which should be investigated, such as whether one of the parties in either the questioned insider transaction or in the measuring transaction with outsiders makes tangible or intangible property available to the other, whether there is a service fee or royalty involved, etc. The Service then states that where there are no independent transaction prices available as gauges, the calculation of a fair arm's length price should be determined on the basis

⁶⁴ Treas. Reg. § 1.482-1(c) (1962).

⁶⁵ 1963-1 Cum. Bull. 490.

of a rate of profit representative of the rate of profit applicable in comparable businesses. Again, the ruling recognizes that a host of factors regarding services, royalties, availability of facilities, and similar factors all have a bearing on the matter of determination of a fair profit. Even the slightly expanded concept of arm's length price as set forth in Revenue Procedure 63-10 is disarmingly simple when stated. It is as disarmingly simple as the phrase "fair market value" so prevalent in the tax laws. Like the latter, it is in practice an invitation to controversy.

If there is any "preventive medicine" which may be practiced in this area, it is in the realm of "building a case" before or at the same time as there is a transaction which is likely to be challenged under section 482. Evidence of appraisals and determinations of prices chargeable in an arm's length transaction are apt to be more impressive to both revenue agents and judges if they are secured contemporaneously with the happening of the occurrence which makes them significant. If real estate is to be sold to an affiliated corporation and if the transaction may some day be challenged under section 482, the taxpayers involved are obviously in a better position in the audit or in litigation if it can be shown that before the intercompany sales price was determined, an expert and independent opinion as to value was secured. Once the transaction has been challenged by a revenue agent, an appraisal secured thereafter (which in the normal course would mean at least a year after the occurrence of the transaction) is somewhat suspect.

The recent decision of the Tax Court in *South Tex. Rice Warehouse Co.*⁶⁶ points up the problems to the taxpayer in establishing that transactions between related entities were had on the same basis as would have been accomplished in an arm's length transaction between unrelated parties. In *South Tex. Rice Warehouse Co.*, individual members of four families owned stock in a corporation which was engaged in the business of operating rice storage warehouses. The corporation leased its warehouse and related assets to a partnership consisting of all but two of the stockholders in the corporation. The Service attempted to allocate all of the income of the partnership to the related corporation on the basis of sections 61(a) and 482. The Tax Court rejected the Commissioner's contention that the partnership was a sham entity which should be disregarded for income tax purposes. On the contrary, the court found that the partnership was organized "for the business purpose of transferring to the adult children of [two of the adult stockholders] the fathers' interests in the rice drying and warehousing operation, while permitting the fathers to retain their

⁶⁶ *South Tex. Rice Warehouse Co.*, 43 T.C. No. 44 (Jan. 29, 1965).

ownership interest in the physical properties."⁶⁷ This disposed of the Commissioner's arguments based on section 61(a). However, the Tax Court went on to consider the Commissioner's arguments under section 482 in terms of rearranging the rental charges paid to the corporate owner of the property by the partnership lessee.

The rental for the properties had been fixed by the taxpayers at \$48,000 per year. The taxpayers' evidence regarding the fixing of the rental consisted of the testimony of several of the partners and of an expert witness. The testimony indicated that there had been actual negotiations regarding the fixing of the price and that an attorney who had been consulted when the plan was in the formative stage had advised the parties that they could lease the property but would have to pay a reasonable rent. Despite the existence of such a record, the Tax Court approved the Commissioner's action in resetting the rent at \$78,000 per year. The Tax Court relied upon the following factors to justify its approval of the Commissioner's action:

1. There was testimony to the effect that the leased property had a fair market value of \$700,000 and the "witnesses in no way reconciled their opinion as to a fair rental value of the assets with their testimony as to the fair market value of those assets." The Tax Court concluded that the opinions as to a \$700,000 fair market value and a \$48,000 per year fair rental value "seem inconsistent."
2. Shortly before the date of the lease, the corporation had built a bulk storage facility which qualified for accelerated amortization on a five year basis. The Tax Court concluded that the "quickie" amortization of this facility would have amounted to \$33,000 per year, whereas the allocable part of the rent fixed for the properties would have amounted to only \$15,000 per year.
3. The taxpayers' expert witness did not explain certain of his conclusions which, in the view of the Tax Court, involved significant factors for purposes of determining the fair rental value of a facility such as that involved.

These bases for the Tax Court's conclusions regarding the fixing of a fair rent are discouraging to a taxpayer and demonstrate that he has an uphill battle in establishing that his transaction was handled on a basis comparable to that which would have been achieved in an arm's length transaction between unrelated parties. On the other hand, the comments of the Tax Court regarding the significance of the attor-

⁶⁷ *Ibid.*

ney's advice that the rent should be fixed at a reasonable amount are nothing short of startling in their implications. In this connection, the court stated:

[W]hile we do not doubt that the matter [of the rental figure] was negotiated and the result of the negotiation was the \$48,000 figure, the logical inference for [*sic*] the record as a whole is that the negotiation was not an arm's length one but was for the purpose of satisfying the condition that the attorney who had been consulted by the prospective partners had placed as a requirement for the transaction not being questioned tax-wise, "that they could lease the property but . . . would have to pay a reasonable rent."⁶⁸

Since there is nothing in the case to indicate that the attorney's advice regarding the importance of fixing a fair rental was other than a good faith admonition, it is difficult to understand why the presence of such a comment in the initial stages of the transaction should make the resulting negotiations suspect. The presence of this comment in the Tax Court's opinion places tax counsel in an untenable position. The implication is that if tax counsel senses that a transaction may be attacked under 482, his perfectly good faith advice to cast the transaction in such a form that it can pass the arm's length transaction test may in itself be construed as evidence that the transaction flunks the test.

Despite this disturbing feature of the *South Tex. Rice Warehouse Co.* opinion, it is self-evident that a competent and ethical tax counselor should continue to advise clients to arrange their affairs so as to be in the best possible position to resist a section 482 attack.

The Commissioner has not been wholly successful in establishing the arm's length transactions test as the only one applicable for testing allocations in 482 cases. In *Frank v. International Canadian Corp.*,⁶⁹ the decision of a district court had approved inter-company pricing based upon costs plus a 6 percent profit, regardless of whether such a price constituted the same price which would have been secured in a like transaction with a stranger. In so ruling, the court of appeals pointed out that the government's arguments on this issue found little support in the record. The tenor of the court's opinion, however, indicates that the arm's length test is not exclusive and that in appropriate cases a reasonable return or reasonable profit test may be applied. Nonetheless, it is likely that the Service will continue to stress the arm's length transaction test.

⁶⁸ Ibid.

⁶⁹ 308 F.2d 520 (9th Cir. 1962).

Standards of Judicial Review

The courts have frequently stated that to secure a reversal of the Commissioner's actions in shifting tax factors pursuant to section 482, the taxpayer must establish that the action of the Commissioner was arbitrary and that he abused his discretion in applying the section.⁷⁰ In reading the cases it is difficult to discern that the taxpayers' burden of proving that the Commissioner's actions in applying section 482 were arbitrary or constituted an abuse of discretion is appreciably greater than the burden cast on taxpayers in most civil tax litigation, *i.e.*, the burden of overcoming the presumptive correctness of the Commissioner's determinations. One would assume that the burden of proving that any action of a public official is arbitrary or capricious would be well nigh unbearable. The fact that the courts have frequently reversed or modified the Commissioner's action under section 482 demonstrates that this burden can be and often is sustained.

In *T. R. Vardeman v. United States*⁷¹ the court disapproved the Commissioner's action in allocating all of the income of a corporation to a related partnership. After reciting fact and reasoning which seemed no different than that involved in hundreds of other cases in which a taxpayer disagrees with a Service determination, the court concluded that in disregarding the corporation and allocating its income to the partnership the Commissioner "acted arbitrarily and abused his discretion, if any, to so act."

*Bank of Kimball v. United States*⁷² involved a bank and a related insurance agency partnership composed of bank stockholders. The partnership used the bank premises and facilities. The Commissioner allocated the common expenses according to the ratio that the incomes of each bore to the total incomes. The court concluded that this method of allocation was "arbitrary, unreasonable, and contrary to the evidence." The court went on to reallocate \$750 of expenses from the partnership to the bank. Ironically, the court, in rejecting the Commissioner's allocation as arbitrary, admitted that the evidence on this issue was not precise and proceeded with its own allocation on the basis of the *Cohan* rule.⁷³

In *Motor & Indus. Fin. Corp. v. Scofield*,⁷⁴ the court, in rejecting the Commissioner's method of allocating expenses among affiliated corporations on the basis of their proportionate incomes, found that there was no substantial evidence in the record to support such a method. Such a basis for decision seems more consistent with a re-

⁷⁰ 7 Mertens, Law of Federal Income Taxation § 38.63 (1942).

⁷¹ 209 F. Supp. 346 (E.D. Tex. 1962).

⁷² 200 F. Supp. 638 (S.D. S.D. 1962).

⁷³ *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930).

⁷⁴ 55-1 U.S. Tax Cas. ¶ 9493 (W.D. Tex. 1955).

versal of the Commissioner because he was wrong rather than because he acted in an arbitrary and capricious manner.

The Tax Court has concluded that in a section 482 case it is not required to accept all parts of the Commissioner's determination.⁷⁵ This seems to be further proof of the proposition that judicial review of section 482 cases is not fundamentally different from that in other areas.

Chief Judge Hutcheson of the Fifth Circuit in *Pearson Motor Co. v. Commissioner*⁷⁶ wrote a concurring opinion solely for the purpose of stating his disagreement with Judge Tuttle's dissenting opinion regarding the scope of judicial review of the Commissioner's actions under section 45. Chief Judge Hutcheson rejected the view that a determination under section 45 is (in his words) "almost if not quite sacrosanct and unreviewable."

The concurring and dissenting opinions in the *Pearson Motor Co.* case point out that in practice the standards for judicial review of 482 determinations are not fundamentally different from those prevailing elsewhere in the tax law.

CONCLUSION

Both the increasing volume of litigation and the recent experience of practitioners indicate that the Service is increasingly utilizing section 482 in income tax audits. The Service is turning to section 482 not only as a principal weapon in attacking many taxpayer transactions, but is also using it as a supporting weapon in cases in which other sections of the Code and other rules of tax law constitute the principal weapons. One can anticipate that this use will be accelerated.

The principal and still undecided issue regarding the application of section 482 is whether that section can be used to accomplish a "consolidation" of the net incomes of related taxpayers. On other issues regarding the scope of 482, the courts, through judicial review of the Commissioner's determination, have imposed limits on his action by using standards not fundamentally different from those relied upon in other areas.

⁷⁵ *Nat Harrison Associates, Inc.*, supra note 40; *Pauline W. Arch*, 42 T.C. 114 (1964).

⁷⁶ 246 F.2d 509, 515 (5th Cir. 1957).